THE GLOBAL STRUCTURE OF FINANCIAL MARKETS

An overview

Edited by Dilip K. Ghosh and Edgar Ortiz

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GLOBALIZATION OF BUSINESS AND FINANCE AND EMERGING CAPITAL MARKETS

*Edgar Ortiz**

INTRODUCTION

Growth in trade and investments, important changes in production and technology, meaningful innovations in telecommunications and computer applications, and a generalized trend towards liberalization and deregulation of domestic and international markets have led during the last two decades to a closer and deeper interaction among international markets, e.g. economic and financial globalization. As a result the structure of financial markets has changed significantly and new international business opportunities, operations, networks and challenges have appeared. Correctly, changes at the end of the twentieth century have been identified as an early stage of another "great leap forward." (Tung and Miller, 1990), Financial systems from both developed and developing countries have been subject to change. However, transformations in the developing countries have been deeper because most of them were characterized by some form of "financial repression" and protectionism, Hence, those changes could be characterized as a systemic transition from highly state-intervened to market-oriented and open economies. In addition, financial transformation in the developing countries could be identified as a strategy followed to promote favorable Links with international financial markets, and as a transition to higher stages of economic development. Finally, in some cases, this situation could be also identified as an about face from stateled socialism into capitalism. The domestic and international factors that impact the nature of these promising transitions need to be further analyzed.

A key component of recent changes in the financial sector from the developing countries has been the impressive growth and internationalization of their capital markets. These markets have acquired great importance for the mobilization of international resources to support the continuing and expanding needs of those countries to finance their economic activity. However, this role cannot be successful unless some local inefficiencies that reinforce each other are eliminated. High returns and a favorable prospective, involving migrations to competing markets, have fueled a great deal of interest in investing in and studying the characteristics of the most successful "emerging capital markets." Nevertheless, the literature has neglected to examine the relationship and implications that inefficiencies derived from traditional patterns of corporate governance, asymmetrical information and weak links of foreign capital flows with the real sectors of the economy can have on the integration of those markets with the world economy. Possible instabilities due to the integration of the local markets with regional and global markets need to be assessed, too.

This chapter deals with those issues. Its aim is to explain whether globalized business and global finance contribute to eliminate the roots of those problems. The chapter is organized in five sections, in addition to this introduction. The first of these deals with globalization and corporate governance and agency problems in the developing countries; the next focuses its analysis on the problems related to asymmetrical information; this is followed by a section which examines the nature of capital flows to the developing capita! markets. In the penultimate section possible impacts of economic and financial integration with trading partners and the liberalized world at large are analyzed. The final section forms the conclusion of the chapter.

CORPORATE GOVERNANCE AND EMERGING CAPITAL MARKETS

In the developing countries family owned businesses are still the preferred form of corporate governance. There is no separation between ownership and management. This is the case even for large firms that play an important role in the economy and for firms registered at the local stock market (Fischer *et al*, 1994; 1995a). Often, these businesses have evolved into complex but limited size conglomerates, known as "groups," composed of rather small firms in different lines of business, many times without a strong relationship among them. The group is a multi-enterprise corporation that draws its capital and management expertise from the family and a tight circle of friends. In modern times, their presence was favored by protectionism, which led to the formation of natural monopolies. That is, monopoly profits due to protectionism allowed groups to secure and sustain a share of the market.

This form of ownership has brought about several types of inefficiencies that deter market activity. First, it must be mentioned that capital markets remain relatively small because the number of shares released to the market is scanty, because owners-managers do not want to lose control of the corporation. Second, it must be pointed out that firms become inefficient, and because of their protected in ward-oriented production and sales, exports are low and group firms are not competitive internationally.

To adjust to changes in world economics, developing countries have liberalized and deregulated their markets and opened their economies to foreign trade and investments. Their inward-oriented development model based on "import substitution" has been replaced by a new market- oriented and outward-oriented development model. Financial liberalization and deregulation has meant an end to financial repression and enabled a profound re-structuring of their financial sectors. Five important changes in the structure of the financial sector can be identified in recently liberalized and deregulated markets from developing countries:

1 Emphasis on private financial intermediation. This has meant strengthening local institutions and orienting them towards market activity. In some cases it has also meant privatization of nationalized institutions, like the commercial banking system in Mexico; it has also meant diminished intermediation through development banking institutions- Following World War II the number and operations of these institutions skyrocketed, partly as a response to the lack of well-developed securities markets. Their growth and goals were often unplanned; rather they resulted from populist practices, and their administration became inefficient. Nevertheless, although their role was in general positive in promoting economic development, their overwhelming presence inhibited the growth of financial markets.
2 A generalized move towards "universal banking." Although specialized banking institutions still are an important part of the financial sector, most developing countries are promoting "multiple services" banking, "all in one counter services," This change has been prompted by the need to promote economies of scales and scope, and better and wider financial services.
3 The creation of new financial institutions, particularly non-banks. Since savings is the key to promote economic development, and for many countries the propensity to save has remained low, the creation of nonbank institutions has been seen as a means to increase local savings and investments, as well as to lower overreliance on foreign debt-
4 Impressive growth and greater importance and internationalization of local securities markets. Moreover, governments began using money and capital markets to fund government needs, to end with traditional inflationary alternatives. Corporations also increased their acquisition of funds from the local securities markets. Although banking institutions also internationalized their operations, and mobilized international savings to the local economy, the securities markets became in the late 1980s and early 1990s the main mechanism to mobilize international

savings to furid the government and local firms (Classens, *et al.,* 1993; Gooptu, 1993).

5 Increased participation of foreign financial intermediaries in local markets, In some countries this marked the end of total closure to foreign entries. Greater participation of foreign financial intermediaries has taken place in varied forms: outright establishment of subsidiaries or branches, acquisitions of local institutions, and joint ventures with local intermediaries.

Liberalization and deregulation, should help to end inefficiencies derived from protectionism. They should also lead to the formation of larger and internationally competitive firms. Nevertheless, global finance and the changing structure of local financial markets does not seem to be altering existing patterns of corporate ownership and control. Indeed, it can be affirmed that the internationalization of corporate financing is rather favoring further forms of capital concentration. This is because firms from developing countries have issued neo-equity titles with limited rights at international capital markets. Corresponding to this type of issue are American Depository Receipts, Global Depository Receipts* "neutral shares," authorized by the authorities and sold exclusively to foreigners, and country funds. Free subscription shares compose only a small part of shares sold to foreigners. The main reason being an overhang of traditional standards which limit foreign investment in local firms to certain levels, commonly 49 percent of total capital.

The limited vote characteristic of securities sold to foreigners has allowed local entrepreneurs to retain the control and ownership of the corporation. It is worth noting thai in some cases funds raised at international markets have been used to purchase the interests of other majority shareholders, concentrating ownership and control in fewer hands. An example is the case of Televisa, Mexico's multinational television and entertainment corporation; following the sale of American Depository Receipts (ADRs) in 1992 its property concentrated in one family, displacing two other Large family shareholders (Ortiz, 1996).

Furthermore, limited rights has also led to a lack of identification of foreign investors with local firms. Mostly they have been only interested in economic gains — high returns. That is one reason why investments in the emerging markets have been mainly institutional, carried out by mutual funds and pension funds with no interest in the decision-making processes of the corporations themselves. Finally, the permanence of traditional forms of ownership and control also implies that the growth of domestic corporations in the developing countries will be limited. Current owners are not interested in sharing control of the corporation with potential large shareholders from the local and international markets. Neither will investors seek to invest indefinitely in low growth corporations. All this means that the internationalization of financing of firms from developing countries cannot contribute decisively to the formation of viable corporations, large and capable of taking advantage of the opportunities open to them by global business. It also means that local firms will not face agency problems derived from widespread ownership. However, some situations» like unfavorable business conditions and greater needs for funds by local firms, could lead to conflict between limited vote shareholders and common shareholders. Indeed, since neo-equity shares resemble debt instruments, to sustain investment in local firms, conflicts will have to be solved through swap schemes, for instance ADRs for common capital, which would open the doors to foreign shareholders to a full participation in the affairs of the corporation, even as majority holders. Once this takes place, agency problems would appear and firms from emerging markets would enter a learning process to deal with them through market mechanisms.

The need for additional funding to support projects related to exports, as wcil as to purchase advanced technologies to remain competitive might force some groups to open up a bit to foreign capital. However, the initial stages in this direction would be rather characterized by the formation of joint ventures and strategic alliances. Thus, possible agency conflicts would arise between a domestic group and a foreign multinational firm. Many more years would still have to pass till emerging markets mature, and agency problems and other problems have similar characteristics as those present in the developed markets today.

ASYMMETRICAL INFORMATION AND FOREIGN PORTFOLIO INVESTMENTS

An important extension of closed ownership and management in developing countries is the endurance of asymmetric information. Market participants have unequal access to key financial information about corporate performance, or even to price and volume quotation information associated with securities trade. In addition to releasing to the market a limited amount of capital, owner-managers do not intentionally deliver key information to diminish challenges from potential new shareholders in order to retain control of the corporation.

The problem is magnified by the fact that accounting standards in many developing countries are frail or differ significantly from developed country norms. In addition, underdeveloped publishing and computer information systems, as well as underdeveloped corporate and financial market rating and analysis limits the availability and quality of information. Finally, unreliable macroeconomic data restricts the scope and soundness of country risk analysis and systemic risk determination, i.e. the relationship between local and international variables with market performance from emerging capital markets.

Besides local problems that asymmetrical information generates, it is important to recognize that at the international level asymmetrical information leads to extremely high required rates of return by foreign investors and to problems of adverse selection which can lead to important fragilities in domestic financial markets; in turn, this could end in severe financial crisis when international investors adjust their portfolios to overcome undesired risk levels and lower than desired rates of return (Mishkin, 1991).

Although asymmetrical information cannot be associated with all corporations from developing countries participating at international financial markets, it is important to note that difficulties in obtaining high quality information from underperforming borrowers or corporate capital issuers from emerging markets will cause good companies to end up paying high interest rates on their debt instruments and high rates of return on their equity issues* which is known as the lemon effect (Fischer *et al.,* 1995b). Cost of capital for these corporations would be abnormally high and might weaken their competitive edge, if these payments increase significantly because of increased demand for international funding, or because of some crowdmg-out effect on international resources, portfolio investments in the emerging markets would decline, which in turn would lead to a fail of corporate investments and aggregate economic activity.

Summing up, asymmetrical information at the international level lessens the confidence of investors, reduces the liquidity of secondary markets, thereby increasing costs of capital and transaction costs, which in turn leads to underinvestment's by firms. Furthermore, since investors are affected both in relation to the prospects of emerging markets corporations, or else with respect to market and macroeconomic perspectives, financial fragility might ensue.

As a result what can be experienced in developing countries is remarkably large, indeed overgrown, capital markets, dynamic but inefficient and fragile. Weak efficiency might be present, which seems to be a general attribute of the most important emerging markets, but unfair pricing would also be present. Semi-strong and strong efficiency would not be present.

Similarly, inefficiencies and asymmetrical information make it difficult to monitor the market and to manage portfolio holdings rationally. For this reason, international investors, particularly professional managers of institutional funds, endeavor to cash out capital gains from their portfolios and to seek alternative investment opportunities in other markets, which increases market volatility. Finally, asymmetric information can also affect intermediaries such as dealers or specialists, which leads to wider bid-ask spreads, high commissions and floating costs, increasing market inefficiencies and the cost of corporate capital. It should also be pointed out that in some cases portfolio account managers from developed countries might deliberately withhold asymmetrical information problems to their clients to secure for their companies and themselves large profits associated with sales and purchases of emerging market securities.

To overcome these problems it is therefore imperative to improve information systems in the developing countries and to open up further local firms to foreign investors. Widespread ownership, which includes foreign ownership, and reliable and well-distributed financial information are key factors to promote the rise of internationally competitive firms in the developing countries, as well as the consolidation of efficiency in their markets.

REVERSIBILITY OF CAPITAL FLOWS TO THE DEVELOPING CAPITAL MARKETS

The rise of capital markets has been largely determined by massive capital flows from the developed countries, which substituted previous patterns of foreign debt financing. Four stages of foreign funding to the developing countries can be identified in modern times (Ortiz. 1996):

1 moderate borrowing from international official institutions;
2 excessive borrowing from private international banking institutions;
3 restricted credit during the debt crisis;
4 massive mobilizations of international savings for lending to governments and corporations, and equity funding to private corporations through the securities markets.

Following World War II, foreign debt from the developing countries came mostly from official international organizations, mainly the World Bank, the international Monetary Fund, and some regional development banks such as the Interamerican Development Bank, the Asian Development Bank, etc., and some binational credits established to promote trade, i.e. exports from the developed countries/imports from the developing countries. Most credits were granted in relation to specific development projects and careful cost—benefit analysis. Under this scheme, foreign debt remained reasonably low and manageable.

A new pattern of development financing appeared as a result of the limited resources of official international organizations, increasing developing needs, and the oil crisis of the early 1970s. Originally, this crisis, along with exchange rate flotation, due to the collapse of the Bretton Woods agreement, increased sharply the needs of developing countries to meet payments due to higher oil imports. Foreign debt was used to cover these needs, but this led to profound imbalances in the current accounts of most developing economies. However, the rise of oil prices also let! to a high concentration of foreign exchange revenues among oil exporting countries. Since those revenues exceeded their capacity to absorb capital, they ended as deposits at international private banks — petrodollars. Banks allocated substantial parts of those funds to foreign loans to developing countries. Debt from these countries thereby became debts to private banking institutions.

Imprudent borrowing and lending followed. Countries borrowed beyond their capacity to pay. Bankers lended, omitting formal credit analysis, Loans were given to countries based only on country risk analysis and went to a general fund often used by governments to cover current needs, not to promote specific development projects.

Unfavorable conditions at international markets caused sharp increases in interest rates and a severe decline in oil prices. Although this decline favored oil importing countries, those two shocks severely affected highly indebted countries, particularly oil exporting countries, e.g. Mexico. As a result, highly indebted countries were unable to meet their international obligations. Mexico astonished the world in August 1982 when announcing that it could not meet its international obligations. That announcement marked the beginning of the debt crisis of the 1980s. Consequently, a new stage on development financing came about: restricted international credits. Most loans were destined for the repayment of existing debts. No fresh funds were available for development. Indebted countries restricted imports and increased exports, mainly due to large devaluations of their currencies rather than by productivity gains. But all revenues were directed to servicing foreign debt.

A new stage of foreign financing began by the end of the 1980s. The situation improved as a result of meaningful debt rescheduling, a cut in interest rates and in the amount to be paid, due to arduous negotiations throughout the years, and above all the Baker and Brady plans which favored large indebted countries such as Mexico.

Simultaneously, many developing countries had begun to undertake ambitious economic and financial reforms to adjust their economies, and to respond to the challenges of globalization. Developed countries also adopted some important measures allowing local investors and institutions to invest in foreign securities, as well as allowing the participation of foreign firms in their financial markets using neo-equity instruments, or else allowing private placements. This is the case of Rule 144-A, for instance, which opened up the door of US capital markets to firms from the developing countries through issues of American Depository Receipts and private placements.

In this manner funds began to be mobilized to firms from the developed countries, and their securities markets grew impressively. Financial liberalization and innovations paved the way for similar practices to become extensive in developing money markets. There, government securities were highly demanded by international investors, as in the case of the Mexican Tesobonos, a short term instrument tied to the value of the dollar. In brief, developing financing acquired three new important characteristics which contrasted sharply with previous stages. First, the mobilization of international private savings to the developing countries was made through securities markets, both money and capital markets. Second, the mobilization of international savings was not limited to sovereign debt; funds to support corporate loans or equity issues were also mobilized. Finally, international savings from the developed countries were mainly channeled by institutional investors. All this has led to: (a) the diminished importance of commercial banks in the developing economies, (b) a transformation in the nature of domestic debt, for significant parts of domestic debt have been held by foreigners, and (c) increased international reserves needs; in addition to regular needs for trade, transference, debt servicing, etc., holdings of reserves must also be sufficient to cover flows in the financial markets, which in some circumstance could involve massive withdrawals of funds from local institutions. This raised the question of whether or not private capital flows to emerging markets are sustainable. It also implied that since debt holdings became less important the possibility of another crisis of payments is unlikely.

Most analysts believe that a generalized reversal of flows, leading to a financial crisis, is unlikely. However, a "highly foreign financed" economy could face some problems due to short levels of international reserves. Many countries may experience volatile financial flows (Dadush *et at.,* 1994). One important argument against reversal is that half the flows to developing economies correspond to foreign direct investment. However, further analysis reveals that international portfolio holdings have been superior to foreign direct investments in the last few years. In addition, significant amounts of foreign funds correspond to short term securities from emerging capital markets. Any instability in the emerging capital markets induced by internal or external forces would therefore lead to significant portfolio withdrawals.

On the other hand, equity flows are also subject to reversals. Most portfolio investments at emerging capital markets have been made at the secondary markets. Hence, portfolio investments have not been linked to corporate investments. Partly, this has been the result of light corporate control and the nature of "neutralized" capital sold to foreigners, previously examined. Economic short term gains has been the guiding motivation for foreign portfolio investors. That gives those investments the character of liquid assets. Moreover, large proportions of those investments have been carried out by institutional investors. Therefore, in case of an unfavorable situation, mutual funds and pension funds would make large withdrawals from their holdings in a faltering emerging capital market. It is also worth noting that equity instruments are priced at the market; the trend has been towards appreciation. Hence, remittances would be based on those amounts. That means increased pressures on international reserves, A developing nation would have to count with higher amounts of dollars than those nations which entered the international capital markets earlier.

Thus, the determining factor as to whether foreign investments are in hot or cool money seems to be the link that those investments establish with the real sectors of the economies of developing countries. If the links are weak, no matter how large or small they are, their holders would be easily tempted to leave an emerging market when unfavorable conditions arise. If the links arc weak, foreign exchange revenues from those investments would only temporarily strengthen the nation's international reserves. If they are not "neutralized" inflation could result. However, their use to support the external sector of the economy can also be harmful. In the case of Mexico, for instance, an overvalued peso and high imports of intermediate and consumption goods were largely supported with dollar reserves from foreign portfolio investments. An unsustainable situation (see Cabello, Chapter 5 in this volume).

It is worth noting that an international financial crisis cannot be ignored. The Mexican crisis of December 1994 showed that the expectations of international investors change drastically when one large emerging market fails, which also leads to defensive portfolio withdrawals from some other markets; this was the essence of the "tequila effect" of 1994 and early 1995. Negative impacts could become extensive to developed countries as a result of underperforming and losses in the foreign holdings from key institutions. Moreover, capital markets from the developed countries would also suffer a set-back because trade on emerging capital issues is made through them and their local intermediaries.

At any rate, a financial crisis originating from investments in emerging capital markets, limited to a specific country or a group of countries, would be of a different nature and would be played by different actors than in the debt crisis of the 1980s. Payment difficulties would arise because, as pointed out, large shares of portfolio investments in the emerging securities markets have been made in the money markets. To that should be added possible insolvencies originating in the bonds markets and insolvencies originating from loans made by corporate and financial institutions to foreign private banks. But the main thrust of the crisis would be related to massive withdrawals from the equity markets-

Concerning the actors, private international banks would still be an important interested party with which corporations and governments would have to negotiate a solution. However, the main parties would be institutional investors from the capital exporting countries, and private institutions from the capital importing countries. It is precisely for this reason that solutions will have to be market-oriented, with government support from developed and developing countries being necessary. The most feasible solution would be a new form of swaps, as previously suggested: exchange neutral equity for shares with full rights. To allow this mechanism to work, governments would have to liberalize their foreign investments laws. Since Mutual Funds and Pension Funds do not by their very nature participate directly in corporate management, the solution should also include the establishment of some sort of trusts, associated with the institutional investors, to participate in the management of the emerging market corporations.

ECONOMIC AND FINANCIAL INTEGRATION AND EMERGING CAPITAL MARKETS

The surge in capital flows to the developing countries has made them part of globalized business and globalized finance. Inefficiencies and protectionism still present in both developed and developing countries have prevented the full integration of emerging capital markets with the leading international financial markets. Interest rates and required rates of return between developed and developing countries differ significantly, underlying the existence of segmented international markets. Thus, in the case of the emerging markets, it is internationalization rather than integration which should be acknowledged. They have become valuable mechanisms to overcome financial segmentation. Financial opening has induced firms from the developed countries to acquire capital in foreign markets. Similarly, foreign investors have been induced by high returns to purchase securities from corporations from developing countries.

At any rate, the internationalization of emerging capital markets should lead to further international financial integration. For the developing countries this means that to take full advantage of opportunities offered by international markets to increase local investments, risks associated with integration must be taken into account. One important aspect that must be considered is the impact of financial integration on local business cycles. Integration to the world markets implies higher correlation with their movements, and higher affinity with the factors that influence market activity in the developing countries. In this respect, the business cycles of developing countries will begin to show similar paths and characteristics as those from the developed countries. An important implication of this is that conventional tools to overcome undesirable trends will not be sufficient. Indeed, the success of the policies undertaken to end recessionary conditions, for example, would largely depend on the economic and financial policies of the developed countries. That is, for the developing countries, due to the size of their economies, financial integration will lead to a loss in the effectiveness of conventional economic policy tools, particularly monetary and financial.

Moreover, since economic integration is taking place above all among regional blocs, this means that the small countries in a bloc would depend significantly on the monetary and financial policies of their large partners.

However, since large blocs have been forming as a "second best" response to promote growth, productivity and increased competitiveness of local firms in relation to firms from other blocs, it is important to note that economic and financial policies should therefore begin stressing regional actions. Economic and financial policies should stress the elimination of asymmetries among partners. Indeed, to built up viable corporations, policies for the entire bloc should be sapped. For instance, the North American Free Trade Agreement should be revised to ensure that Mexico participates fully in regional growth. Regional integration is essentially a strategy to promote economic growth. Trade and investments in the real sector need an adequate financial infrastructure. Hence, greater harmonization of financial regulations must be sought among trading partners, and market segmentations should be eliminated. In relation to capital markets this means that various mechanisms should begin to be established to end inefficiencies in the Mexican stock market, the weaker partner. This means, in affinity with the analysis here presented: promoting wider corporate ownership, opening up more local firms to foreign investors, improving corporate and capital market information systems, tying up portfolio investments to real corporate investments, the prevention of reverse flows, and the harmonization of financial regulations.

CONCLUSION

The dramatic changes in world economics and finance which have taken place during the last two decades have restructured the traditional composition of world financial markets. The new international context includes profound changes in the financial systems from the developing countries and the internationalization of their money and capital markets. Those markets still suffer some inefficiencies that prevent developing countries taking full advantage of global business and global finance opportunities. Above all, those inefficiencies prevent the growth and consolidation of internationally competitive firms. Moreover, those inefficiencies could trigger local and international crises, as well as preventing the smooth integration of developing economies with their trade partners and the globalized economy in general.

It is therefore imperative to identify and analyze the importance of these and other inefficiencies that feed each other and prevent greater welfare levels for the developing countries and for the world at large. Further liberalization of their economies is necessary, while at the same time an institutional mechanism should be created to eliminate asymmetries and harmonize regulations.

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